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IRS OFFERS TO SETTLE TAX ISSUES WITH EMPLOYERS

WASHINGTON -- The Internal Revenue Service is offering employers a chance to resolve disputed tax issues relating to certain accelerated deductions claimed for accrued employee benefits. Under this settlement initiative, employers generally will be able to deduct half the expenses in the tax year they originally claimed them and the remaining half in the year the benefits were paid or were includible in the employees' incomes.

The audit issue involves deductions for benefits such as vacation or severance pay that employees may earn in one year but receive in a later year. Tax regulations generally consider these benefits as deferred compensation, deductible by employers in the year paid to the employees, for vacation pay, or in the year includible in the employees' incomes, for other benefits. However, the regulations provide an exception that allows employers to deduct accrued benefits received by employees within 2½ months of the end of the year earned.

Some companies purchased letters of credit, bonds, or other financial instruments securing these types of benefits within this 2½-month period, then claimed deductions under the exception. The IRS has contested such arrangements, but in a 1996 case (*Schmidt Baking Co., Inc.*, 107 T.C. 271), the Tax Court allowed the deduction. The Court found that the employees had effectively received the benefits within the 2½-month period.

The government neither appealed *Schmidt* nor acquiesced in the decision, and the IRS continued to look at this issue when auditing employers. The IRS found that this type of arrangement generally does not have sufficient nontax business purpose and economic substance to be considered for tax purposes. Therefore, in most cases, the IRS proposed to not allow moving the deductions forward.

In last year's IRS Restructuring and Reform Act, Congress overruled the result in *Schmidt Baking* for tax years ending after July 22, 1998, but left unresolved outstanding audit disputes for earlier years. Congressional conferees asked the Treasury to "consider whether, on a case-by-case basis, continued challenge of these arrangements for prior years represents the best use of litigation resources." The IRS settlement initiative provides a resolution that is consistent with this request.

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Details on the settlement initiative are in Rev. Proc. 99-26, to be published in *Internal Revenue Bulletin* 1999-24, dated June 14, 1999. It will also be available through the IRS Web site, *www.irs.ustreas.gov*.

Taxpayers currently under audit on this issue who are interested in accepting the IRS offer should contact the IRS agent handling their audit by October 1, 1999. Taxpayers who are not now being audited, but who are concerned that this could be an issue for them, should see the Rev. Proc. for specifics on taking advantage of this settlement initiative.

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